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June 4, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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Ms. Magalie Salas
Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

In re Matter of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, **CC Docket No. 96-128**

Dear Ms. Salas:

On June 4, 1998, Marie Breslin (Bell Atlantic), David Cockcroft (BellSouth), Tom Webber (SBC), Jim Hannon (U S WEST), Aaron Panner (Kellogg, Huber), and I met with Larry Strickling, Glenn Reynolds, Bob Spangler, Rose Crellin, Craig Stroup, Greg Lipscomb, Jennifer Myers, and Chris Gerstle of the FCC on behalf of the RBOC/GTE/SNET Payphone Coalition to discuss matters in the above-captioned payphone docket related to the remand from the court of appeals. The attached document reflects the substance of our presentation.

One original and one copy of this letter are being submitted to you in compliance with 47 C.F.R. § 1.1206(a)(2) to be included in the record of this proceeding. If you have any questions concerning this matter, please contact me at (202) 326-7902.

Sincerely,

Michael K. Kellogg

Michael K. Kellogg

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List A B C D E

Payphones II Remand: Ex Parte Comments of RBOC/GTE/SNET Payphone Coalition

I. The Commission Was Right to Set a Market-Based Rate, Rather Than a Cost-Based Rate

A. A market-based rate is preferable to a cost-based rate for several reasons, as the Commission has already noted.

1. A cost-based rate would impose administratively burdensome ratemaking procedures on a competitive industry. Independent payphone service providers have never been required to submit such data and should not be required to do so now.

2. Old-fashioned, rate-of-return regulation is rarely accurate and creates potentially perverse incentives.

3. A cost-based rate must use some measure of average costs; the resulting rate would therefore undercompensate payphones with below-average call volumes or above-average costs. Market prices take such variations into account; a market-based rate can do so as well. A market-based rate therefore promotes efficient payphone deployment.

4. Just as a market-based rate can account for cost differences among payphones, it can account for changes in costs over time. Only very onerous administrative procedures could begin to accomplish the same thing for a cost-based rate.

B. The D.C. Circuit specifically upheld the principle that a market-based rate could satisfy the statutory fair compensation requirement. See Payphones II at 6. The Commission should not back away from a principle that has guided its approach to this rulemaking from the start.

II. The Local Coin Rate is the Most Conservative Starting Point for Determining a Market-Based Rate

A. In the case of dial-around and subscriber 800 calls, it is impossible to rely on the market directly to set a compensation rate because TOCSIA prevents PSPs from blocking dial-around calls (and, effectively, subscriber 800 calls). IXCs therefore have no incentive to pay for such calls, absent intervention by the Commission, and the PSPs have no leverage to compel such payments.

B. It is, however, possible to establish a market-based proxy for dial-around and subscriber 800 calls. This proxy can be used as a default compensation rate if the PSPs and IXCs fail to negotiate a rate.

C. The default rate can be derived by adjusting other market-determined payphone rates. Several starting points were suggested to the Commission:

- 0+ commission rates provide a good analogy to per-call compensation payments on dial-around calls. In each case, the IXC pays a per-call charge to the PSP which is passed on to the caller. Data before the Commission showed that 0+ commissions (which are deregulated and therefore reflect a voluntary, market-based transaction) are well over the local coin rate.

- 0- transfer rates indicate the minimum that IXCs will pay to obtain telephone traffic. Record evidence before the Commission showed that 0-transfer rates exceed 40 cents per completed call.

- Sent-paid toll charges exceed standard transmission charges by an average of $1.40 per call. Again, this amount reflects the amount that a caller will pay for the convenience of using a payphone.

- The local coin rate -- the lowest market-determined rate for a service provided by a payphone -- is the most conservative starting point for determining the default rate for dial-around and subscriber 800 calls. The local coin rate is the lowest level of compensation received on any call made from a payphone.

III. An Avoided Cost Approach, Starting with the Local Coin Rate, Is Both Economically Efficient and Fair

A. Avoided cost pricing is a well accepted regulatory technique for determining the price that the market would set for a product where the market is precluded from working directly because of regulatory constraints. Under an avoided cost approach, the market-determined price for one service is used as a starting point for deriving a regulated rate for another service. Costs unique to the service for which a market exists are subtracted from the market price; costs unique to the other service are added to the market price. The resulting rate thus ensures that the facility owner will earn the same economic return from each service.

B. This technique does not entail "subtracting apples from oranges." By subtracting (or adding) costs associated only with a particular service, the avoided cost technique simply mirrors the result that would obtain in a competitive market where a single facility is used to provide two services. In a competitive market, the facility will earn the same return from each service (taking into account the different costs of each service).

C. An avoided cost approach also results in a "fair" rate within the meaning of the 1996 Act because it ensures that all payphone users make an equal contribution to the joint and common costs of the payphone. As the Commission has repeatedly recognized, most of the costs of a payphone -- the instrument, the installation, the line, maintenance, etc. -- are common to all types of calls. Those who benefit from the placement of the payphone should make an equal contribution to those costs. This will be true whether the user is a caller digging in his pockets for change, a business traveler dialing 1-800-COLLECT, or the subscriber to 1-800-FLOWERS, receiving a call from a customer placing an order from a payphone.

- If anything, an avoided cost approach is conservative. The Coalition has pointed out that allocation of joint and common costs based on relative demand elasticities might mirror market results better than equal allocation. The demand elasticity information in the record indicates that the derived elasticity of demand for dial-around and subscriber 800 calls was significantly less than the elasticity of demand for coin calls. Thus, in a market free of regulatory barriers, the compensation rate on dial-around and subscriber 800 calls would likely be significantly higher than the local coin rate.

D. It is also fair for the "opportunity costs" for each kind of call to be the same, so that the payphone owner is indifferent to whether the phone is used for a dial-around call, a local coin call, or a subscriber 800 call.

IV. The Conditions Necessary for an Avoided Cost Approach are Present Here

A. Where the goal is to reproduce what a competitive market would produce, economic analysis teaches that avoided cost pricing is appropriate where:

1. there is a single facility used to provide more than one service;

2. at least one of the services is sold in a competitive market; and

3. the differential costs between the services are calculable.

B. These conditions are satisfied here.

1. The same payphone is used to provide service to local callers, calling card callers, callers to 800 subscribers, and so on.

   - It has been objected that it is unreasonable to derive a market-based rate for dial-around and subscriber 800 calls from the market rate for local coin calls because the markets are different. But the markets are related in the relevant way: in all cases, the payphone user -- whether a local caller, a dial-around caller, or a 800 number subscriber -- makes use of the common facility.

2. The payphone market is highly competitive and the local coin rate is a genuine market rate. The market need not be perfectly competitive for the avoided cost approach to be valid; so long as the market is effectively competitive, an avoided cost approach will be easier to derive and more efficient than a cost-based rate.

   a. The payphone market has low barriers to entry and exit.

   b. Actual experience indicates that the payphone market is indeed competitive. The Commission was able to rely on the experience of several states in which payphones had already been deregulated for years.

   c. The Court of Appeals in Payphones I upheld as reasonable the Commission's determination that the payphone market could function as a competitive market.

   d. Claims that PSPs can take advantage of "locational monopolies" are unsupported by any evidence. The local coin rate has been deregulated for the better part of a year, yet no state has invoked the procedures for referring potential market failures to the Commission.

   e. Economic analysis demonstrates that the prevailing local coin rate ($.35) is a competitive, market-determined rate.

3. The Commission has correctly concluded that the differential costs between local coin calls and dial-around and subscriber 800 calls are calculable. Some adjustments to the Commission's calculations are appropriate (see Point V, infra), but no one has disputed that the analysis can be done.

C. It has been objected that an avoided cost analysis is inappropriate in this context because, in the case of 800-number subscribers, the party with the ultimate payment obligation cannot make a decision about whether to accept a call from a certain payphone, and that the calling party does not face appropriate incentives to choose cheaper phones. This objection does not hold up for a number of reasons:

1. The point of the avoided cost rate is to set a rate where market failure prevents the market from operating directly. In the case of subscriber 800 calls, the advantage of a default rate based on the local coin rate is that so long as the local coin market is effectively competitive, the local coin rate, upon which the default rate is based, will likewise remain reasonable.

2. During the two-year phase-in period, the default rate is uniform nation-wide, so the need for consumers to shop for cheaper phones is avoided.

3. Targeted call-blocking, which is already technically feasible for the vast majority of payphones and will be virtually universally available by the end of the phase-in period, will permit 800 subscribers to negotiate, through their IXCs, lower rates for certain payphones. For this reason, there are already effective opportunities for 800 subscribers to choose whether to consume payphone services at the per-call rate set by the Commission, to refrain from consuming those services, or to attempt to negotiate a different rate.

4. In all events, this is just a special case of the general structure of 800 service, where the called party, rather than the calling party, pays all toll charges. If an 800 subscriber chooses not to accept calls from payphones because of the additional cost, this is a marketing decision for that subscriber.

5. Dial-around and subscriber 800 calls are appropriately compensated at the same rate for two additional reasons. First, no party has established that there are any cost differences between subscriber 800 calls and dial-around calls; under the avoided cost approach, the two services should therefore be priced at the same level. Second, if PSPs were compensated at a lower rate for subscriber 800 calls, carriers would simply set up regenerated dial-tone operations using 800 numbers to gain an advantage in the provision of long distance service from payphones. The Commission therefore had no option but to set the per-call default rate at the same level for the two types of calls.

V. The Commission's Application of the Avoided Cost Methodology Should Be Perfected on Reconsideration

A. While the Commission's decision to set a market-based rate using an avoided cost analysis starting with the local coin rate was correct, its application of that methodology was flawed. The Commission should address those flaws in its Reconsideration order.

1. Coin Mechanism costs: These costs should not have been treated as avoided or avoidable costs, because without the coin mechanism, the payphone itself would not exist.

2. Flex ANI costs: The Commission erred in setting these rates, because it allocated the cost of the service to all calls, rather than to compensable calls alone. In addition, the data upon which the Commission relied now appears to be suspect.

3. The Coalition's Reconsideration Petition pointed out other flaws, which should be corrected.